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Application of treaty rules to hybrid entities

New provision for the United Nations Model Double Taxation Convention between Developed and Developing Countries to address the application of tax treaties to payments made through hybrid entities

Note by the Secretariat

Summary

The present note introduces the work undertaken by the Committee of Experts on International Cooperation in Tax Matters regarding a new provision for the United Nations Model Double Taxation Convention between Developed and Developing Countries to address the application of tax treaties to payments made through hybrid entities. Annex I contains the proposed changes to the United Nations Model and its commentary. Annex II provides examples to demonstrate the tax treaty issues that could arise in the context of payments made through a hybrid entity. Annex III contains extracts from the United States Model Technical Explanation for corresponding tax treaty provisions.

* E/C.18/2015/1.

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I. Introduction

1. At the 2013 session of the Committee, Henry John Louie (United States) presented his country's approach to the application of the provisions of bilateral tax treaties to payments made through so-called hybrid entities. A hybrid entity, for this purpose, is an entity that two contracting States that are parties to a bilateral tax treaty characterize differently (e.g. an entity, such as a limited liability company, that one contracting State may view as a company and the other contracting State as fiscally transparent (for this purpose, an entity is treated as fiscally transparent if the character, source and timing of taxation of an item of income are unchanged when the item of income flows through the entity)). Mr. Louie explained that the following unintended outcomes may arise when applying a tax treaty to such payments: (a) double taxation because of the inappropriate denial of treaty benefits; (b) non-taxation because of the granting of treaty benefits in unintended cases, such as to third-country residents; or (c) the granting of treaty benefits at the inappropriate level (e.g. the granting of the lower withholding rate on dividends paid to companies when such dividends were derived by an individual shareholder).

2. The principles set out in the Organization for Economic Cooperation and Development (OECD) report entitled *The Application of the OECD Model Tax Convention to Partnerships* are aimed at preventing such unintended results. It has not proven to be the case, however, that all countries, in applying their tax treaties, implicitly recognize those principles. To the contrary, the position of many countries is that the report's outcomes cannot be obtained absent provisions in a tax treaty that explicitly provide for such results.

3. Mr. Louie described a provision that is found in United States bilateral income tax treaties. The Committee discussed the provision and concluded that further work should be done to incorporate such a provision, and thus the report's principles, into the United Nations Model. Mr. Louie observed that the OECD Working Party 1 on Tax Conventions and Related Questions had undertaken the same task in recent years and had made significant progress in drafting a new treaty provision and accompanying commentaries for the OECD Model.

4. While the provision found in United States tax treaty practice and the provision developed by Working Party 1 are broadly similar, the two provisions have some differences. After a discussion of those differences, the Committee concluded that the work on a possible new provision for the United Nations Model should be based on the OECD version. Mr. Louie offered to consult with the OECD secretariat and prepare a short paper for discussion at the 2014 session of the Committee that would incorporate into the United Nations Model the new provision for payments made through hybrid entities.

5. At the 2014 session, Mr. Louie presented a proposed new paragraph 2 of article 1 of the United Nations Model, as well as draft commentary in which the relevant portions of the new OECD Model commentary are quoted. During that meeting, some Committee members and representatives of Member States, including those of the Czech Republic, France and Slovakia, expressed the view that, with regard to payments made through entities located within a third State, the new provision should apply only if an exchange-of-information mechanism is in place between the State of source and the third country.

6. Mr. Louie acknowledged the concerns and explained that he was aware of existing variations of the proposed new paragraph 2 regarding payments made through entities located in third States that restrict the scope to entities located in States that have established an exchange-of-information mechanism with the source State. The Committee invited Mr. Louie to revise the proposed commentary to provide an alternative version of paragraph 2 that would employ such a narrower scope.

7. The Committee was invited to discuss the proposed changes to the United Nations Model and its commentary (see annex I) at its 2015 session.

Annex I

United Nations Model Double Taxation Convention between Developed and Developing Countries: proposed changes to address the application of tax treaties to payments made through hybrid entities

A. Replace article 1 of the Convention by the following (deletions from the existing text since the 2014 session are indicated by strikeout and additions by underlining):

Article 1
PERSONS COVERED

1. This Convention shall apply to persons who are residents of one or both of the Contracting States.

2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. In no case shall the provisions of this paragraph be construed so as to restrict in any way the right of a Contracting State to tax the residents of that State.

B. In the United Nations Model, add the following commentary on paragraph 2 of article 1, which includes changes to the existing commentary, in order to include the text of paragraphs 26.3 to 26.16 of the OECD Model (currently proposed as part of the OECD Base Erosion and Profit Shifting project). Paragraphs 1 to 3 of the commentary on article 1 remain unchanged. Other consequential changes to the commentary on article 1 would be required:

Paragraph 2

4. Paragraph 2 addresses special issues presented by payments to entities that are either wholly or partly fiscally transparent, such as partnerships and trusts. ~~The United Nations Model Convention does not contain special provisions relating to partnerships. The Contracting States are therefore left free to examine the problems concerning partnerships in bilateral negotiations and to agree upon such special provisions as the may find necessary and appropriate~~. The OECD Committee on Fiscal Affairs adopted in 1999 the report entitled "The application of the OECD Model Tax Convention to partnerships". The report deals with the application of the provisions of the OECD Model Tax Convention, and indirectly of bilateral tax conventions based on that Model, to partnerships. The Committee on Fiscal Affairs ~~recognized~~ recognizes, however, that many of the principles discussed in that report may also apply mutatis mutandis, to other non-corporate entities. In that report, references to "partnerships" cover entities which qualify as such under civil or commercial law as opposed to tax law. The wide differences in the views of the OECD member countries stem from the fact that their domestic laws treat partnerships in different ways. In some OECD countries,

partnerships are treated as taxable units and sometimes even as companies, while other OECD countries do not tax the partnership as such and only tax individual partners on their share of partnership income. Similar differences in the tax treatment of partnerships exist in the developing countries. The intent of paragraph 2 is to realize the principles set forth in the report.

5. An important question is whether a partnership should itself be allowed the benefits of the Convention. If, under the laws of a Contracting State, partnerships are taxable entities, a partnership may qualify as a resident of that Contracting State under paragraph 1 of Article 4 and therefore be entitled to the benefits of the Convention. However, if a partnership is treated as fiscally transparent under the laws of the residence State, and accordingly, the ~~a conduit and only~~ partners are taxed on the partnership's income, paragraph 2 provides that the provisions of the Convention should be applied at the level of the partners. ~~the partnership may be disregarded under the Convention, at least in the absence of special rules in the Convention providing otherwise.~~ These general principles are expanded upon in paragraphs 26.3 through 26.16 of the commentary on article 1 of the OECD Model Convention:

> 26.3 This paragraph addresses the situation of the income of entities or arrangements that one or both Contracting States treat as wholly or partly fiscally transparent for tax purposes. The provisions of the paragraph ensure that income of such entities or arrangements is treated, for the purposes of the Convention, in accordance with the principles reflected in the 1999 report of the Committee on Fiscal Affairs entitled "The Application of the OECD Model Tax Convention to Partnerships".[3] That Report therefore, provides guidance and examples on how the provision should be interpreted and applied in various situations.
>
> 26.4 The Report, however, dealt exclusively with partnerships and while the Committee recognized that many of the principles included in the Report could also apply with respect to other non-corporate entities, it expressed the intention to examine the application of the Model Tax Convention to these other entities at a later stage. As indicated in paragraph 37 of the Report, the Committee was particularly concerned with "cases where domestic tax laws create intermediary situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes." According to the Report:
>
> > Whilst this may create practical difficulties with respect to a very limited number of partnerships, it is a more important problem in the case of other entities such as trusts. For this reason, the Committee decided to deal with this issue in the context of follow-up work to this report.
>
> 26.5 Paragraph 2 addresses this particular situation by referring to entities that are "wholly or partly" treated as fiscally transparent. Thus, the paragraph not only serves to confirm the conclusions of the Partnership Report but also extends the application of these conclusions to situations that were not directly covered by the Report.
>
> 26.6 The paragraph not only ensures that the benefits of the Convention are granted in appropriate cases but also ensures that these benefits are

[3] Reproduced in volume II of the full-length version of the Organization for Economic Cooperation and Development (OECD) Model Tax Convention, p. R (15)-1.

not granted where neither Contracting State treats, under its domestic law, the income of an entity or arrangement as the income of one of its residents. The paragraph therefore confirms the conclusions of the Report in such a case (see, e.g., example 3 of the Report). Also, as recognised in the Report, States should not be expected to grant the benefits of a bilateral tax convention in cases where they cannot verify whether a person is truly entitled to these benefits. Thus, if an entity is established in a jurisdiction from which a Contracting State cannot obtain tax information, that State would need to be provided with all the necessary information in order to be able to grant the benefits of the Convention. In such a case, the Contracting State might well decide to use the refund mechanism for the purposes of applying the benefits of the Convention even though it normally applies these benefits at the time of the payment of the relevant income.

26.7 The following example illustrates the application of the paragraph:

> Example: State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company, and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership, and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.

26.8 The reference to "income derived by or through an entity or arrangement" has a broad meaning and covers any income that is earned by or through an entity for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in subparagraph 1 (a) of Article 3. It would cover, for example, income of any partnership or trust that one or both of the Contracting States treats as wholly or partly fiscally transparent. Also, as illustrated in example 2 of the Report, it does not matter where the entity or arrangement is established: the paragraph applies to an entity established in a third State to the extent that, under the domestic tax law of one of the Contracting States, the entity is treated as wholly or partly fiscally transparent and income of that entity is attributed to a resident of that State.

26.9 The word "income" must be given the wide meaning that it has for the purposes of the Convention and therefore applies to the various items of income that are covered by Chapter III of the Convention (Taxation of Income), including, for example, profits of an enterprise and capital gains.

26.10 The concept of "fiscally transparent" used in the paragraph refers to situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the

level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement. This will normally be the case where the amount of tax payable on a share of the income of an entity or arrangement is determined separately in relation to the personal characteristics of the person who is entitled to that share, so that the tax will depend on whether that person is taxable or not, on the other income that the person has, on the personal allowances to which the person is entitled and on the tax rate applicable to that person; also, the character and source, as well as the timing of the realization, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement. The fact that the income is computed at the level of the entity or arrangement before the share is allocated to the person will not affect that result.[4] States wishing to clarify the definition of "fiscally transparent" in their bilateral conventions are free to include a definition of that term based on the above explanations.

26.11 In the case of an entity or arrangement which is treated as partly fiscally transparent under the domestic law of one of the Contracting States, only part of the income of the entity or arrangement might be taxed at the level of the persons who have an interest in that entity or arrangement as described in the preceding paragraph, while the rest would remain taxable at the level of the entity or arrangement. This, for example, is how some trusts and limited liability partnerships are treated in some countries (i.e., in some countries, the part of the income derived through a trust that is distributed to beneficiaries is taxed in the hands of these beneficiaries while the part of that income that is accumulated is taxed in the hands of the trust or trustees; similarly, in some countries, income derived through a limited partnership is taxed in the hands of the general partner as regards that partner's share of that income but is considered to be the income of the limited partnership as regards the limited partners' share of the income). To the extent that the entity or arrangement qualifies as a resident of a Contracting State, the paragraph will ensure that the benefits of the treaty also apply to the share of the income that is attributed to the entity or arrangement under the domestic law of that State.

26.12 As with other provisions of the Convention, the provision applies separately to each item of income of the entity or arrangement. Assume, for example, that the document that establishes a trust provides that all dividends received by the trust must be distributed to a beneficiary during the lifetime of that beneficiary, but must be accumulated afterwards. If one of the Contracting States considers that, in such a case, the beneficiary is taxable on the dividends distributed to that beneficiary, but that the trustees are taxable on the dividends that will be accumulated, the paragraph will apply differently to these two categories of dividends, even if both types of dividends are received within the same month.

26.13 By providing that the income to which it applies will be considered to be income of a resident of a Contracting State for the purposes of the Convention, the paragraph ensures that the relevant

[4] See paras. 37-40 of the Report.

income is attributed to that resident for the purposes of the application of the various allocative rules of the Convention. Depending on the nature of the income, this will, therefore, allow the income to be considered, for example, as "income derived by" for the purposes of Articles 6, 13 and 17, "profits of an enterprise" for the purposes of Articles 7, 8 and 9 (see also paragraph 4.1 of the Commentary on Article 3) or dividends or interest "paid to" for the purposes of Articles 10 and 11. The fact that the income is considered to be derived by a resident of a Contracting State for the purposes of the Convention also means that, where the income constitutes a share of the income of an enterprise in which that resident holds a participation, such income shall be considered to be the income of an enterprise carried on by that resident (e.g., for the purposes of the definition of enterprise of a Contracting State in Article 3 and paragraph 2 of Article 21).

26.14 While the paragraph ensures that the various allocative rules of the Convention are applied to the extent that income of fiscally transparent entities is treated, under domestic law, as income of a resident of a Contracting State, the paragraph does not prejudge the issue of whether the recipient is the beneficial owner of the relevant income. Where, for example, a fiscally transparent partnership receives dividends as an agent or nominee for a person who is not a partner, the fact that the dividend may be considered as income of a resident of a Contracting State under the domestic law of that State will not preclude the State of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend.

26.15 The paragraph only applies for the purposes of the Convention and does not, therefore, require a Contracting State to change the way in which it attributes income or characterizes entities for the purposes of its domestic law. In the example in paragraph 26.7 above, while paragraph 2 provides that half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B, this will only affect the maximum amount of tax that State A will be able to collect on the interest and will not change the fact that State A's tax will be payable by the entity. Thus, assuming that the domestic law of State A provides for a 30 per cent withholding tax on the interest, the effect of paragraph 2 will simply be to reduce the amount of tax that State A will collect on the interest (so that half of the interest would be taxed at 30 per cent and half at 10 per cent under the treaty between States A and B) and will not change the fact that the entity is the relevant taxpayer for the purposes of State A's domestic law.

26.16 The last sentence of the paragraph clarifies that the paragraph is not intended to restrict in any way a State's right to tax its own residents. This conclusion is consistent with the way in which tax treaties have been interpreted with respect to partnerships (see paragraph 6.1 above).[1] That sentence does not, however, restrict the obligation to provide relief of double taxation that is imposed on a Contracting State by Articles 23 A and 23 B where income of a resident of that State may be taxed by the other State in accordance w th the Convention, taking into account the application of the paragraph.

While as a general matter, the Committee is in agreement with paragraphs 26.3 to 26.16 of the commentary to article 1 of the OECD Model quoted above, some Committee members have expressed concerns about the application of paragraph 2 without any restrictions to payments made through entities located in third States. Those Committee members are of the view that the scope of paragraph 2 should be limited to situations in which the source State has in place an arrangement with the third State that permits the exchange of tax information. Such an arrangement could be a bilateral tax treaty or a tax information exchange agreement (including the Multilateral Convention on Mutual Administrative Assistance in Tax Matters). Countries sharing the concerns of those Committee members may wish to adopt the following alternative version of paragraph 2:

2. For purposes of this Convention, income derived through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State, and that is formed or organized:

(a) in either Contracting State or

(b) in a State that has an agreement in force containing a provision for the exchange of information on tax matters with the Contracting State from which the income, profit, or gain is derived,

shall be considered to be income of a resident of a Contracting State, but only to the extent that the income is treated, for purposes of the taxation law of such Contracting State, as the income, profit or gain of a resident. In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State's right to tax the residents of that State.

6. ~~The application of the Convention to partnerships may also depend on the laws of the Contracting States. The laws of the Contracting States also determine the treatment under the Convention of a disposition of a partnership interest.~~

7. ~~If the Contracting States differ in their treatments of partnerships, different articles of the Convention can apply to the same transaction in the two States, which~~

[1] Para. 6.1 of the commentary to article 1 of the OECD Model Tax Convention states: "One issue is the effect that the application of the provisions of the Convention to a partnership can have on the taxation of the partners. Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership. Some States may wish to include in their conventions a provision that expressly confirms a Contracting State's right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other State".

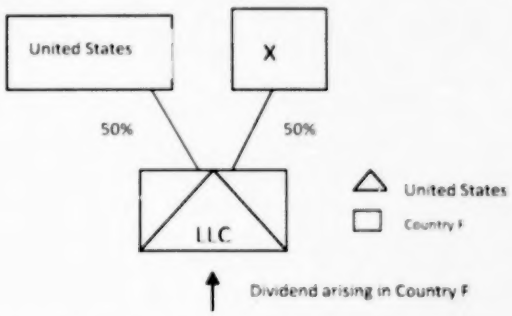
~~may result in double taxation or non-taxation in both States.~~ In response to a comment from a Committee member, Mr. Louie suggested changing the name of the article to "general scope", to more accurately reflect the coverage of the revised article. The Committee might wish to consider making that change in the next version of the Model.

Annex II

Examples of possible tax treaty issues arising in the context of payments made through a hybrid entity

The following examples are intended to demonstrate the possible tax treaty issues that could arise in the context of payments made through a hybrid entity.

Example 1: Payment arising in Country F (treaty partner) to Limited Liability Company, a United States of America entity that is treated by the United States as fiscally transparent.

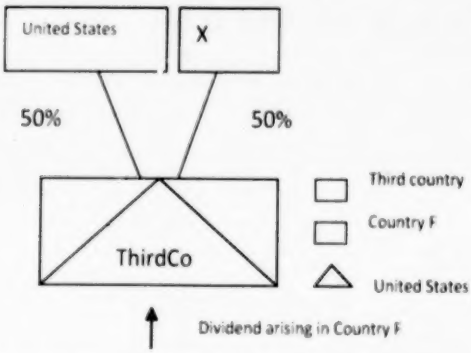


A limited liability company (LLC) organized in the United States and that is treated as fiscally transparent for United States tax purposes receives a dividend arising in the treaty partner, Country F. Country F treats LLC as a corporation under its domestic law. LLC is equally owned by two corporate members, one resident in the United States and the other resident in Country X. Because of the United States treatment of LLC, the United States member is taxed currently by the United States on its 50 per cent share of the Country F dividend. This is the case even though Country F treats LLC as a corporation under its domestic law. It should follow that the United States member should be entitled to the benefits of the United States-Country F tax treaty (assuming that it satisfies any and all requirements set forth in the treaty). It should also follow that the portion of the dividend that flows through to the Country X member should not be entitled to the benefits of the United States-Country F tax treaty. However, as a policy matter, that dividend should be entitled to the benefits of the tax treaty between Country F and Country X, which is the other corporate member's State of residence.

While those desired outcomes are consistent with the principles of the report, countries may not apply their tax treaties in a manner that would reach those results absent an explicit treaty provision. Countries may argue, for instance, that since LLC is not taxed by the United States as a company, the dividend (which they see as being paid to LLC), is not entitled to treaty benefits because it is not being paid to a person that qualifies as a resident of the United States.

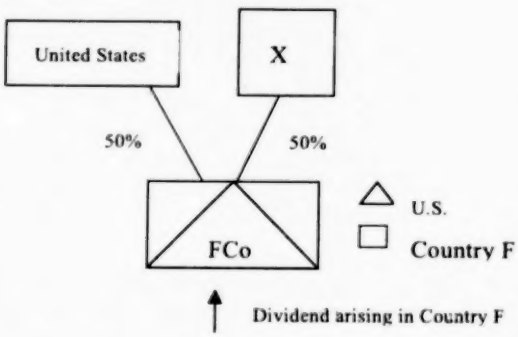
The example also raises the question of how to ensure that the appropriate level of treaty relief is be provided. For instance, if the United States member were an individual, as opposed to a company, it would seem appropriate that Country F apply the withholding rate available to portfolio dividends, as opposed to the rate available for direct dividends.

Example 2: Payment arising in Country F to ThirdCo, a third-country entity that is treated as fiscally transparent by the United States.



ThirdCo is an entity organized in a third country. Both Country F (the source State) and the third country view ThirdCo as a company, but the United States views ThirdCo as fiscally transparent. ThirdCo is equally owned by two corporate partners, one resident in the United States and one resident in Country X. Even though Country F and the third country view ThirdCo as a company, because the United States, as the residence State, views ThirdCo as fiscally transparent (and thus, the United States member is taxed currently by the United States on its 50 per cent share of the Country F dividend), the United States member is treated as deriving 50 per cent of the dividend received by ThirdCo. From a policy perspective, the same outcomes should be reached in this example as in example 1.

Example 3: Payment arising in Country F to FCo, a Country F entity that is treated as fiscally transparent by the United States.

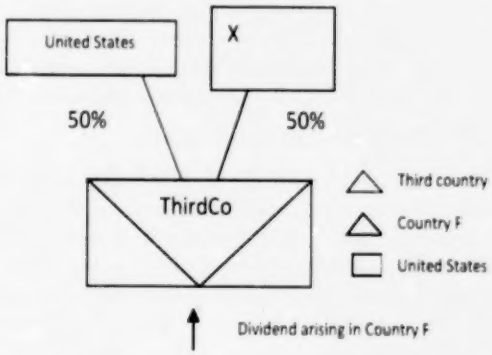


FCo, a company organized in Country F (the treaty partner) and treated as fiscally transparent for United States tax purposes, receives a dividend arising in the treaty partner, Country F. Country F treats FCo as a corporation under its domestic law. FCo is equally owned by two corporate members, one resident in the United States and the other resident in Country X.

This example is distinguishable from the previous examples because, from a Country F perspective, a Country F company is receiving a dividend arising in

Country F. It is therefore reasonable to assume that the United States-Country F tax treaty should not have application, and that Country F should be able to tax the dividend in accordance with its domestic law. Nevertheless, treaty benefits should be available with respect to any future dividends paid by FCo to the United States member.

Example 4: Payment arising in Country F to ThirdCo, a third-country entity that is treated as fiscally transparent by the third country but as a company by the United States.



ThirdCo is an entity organized in a third country. Country F and the third country view ThirdCo as fiscally transparent, but the United States views ThirdCo as a company. ThirdCo is equally owned by two corporate partners, one resident in the United States and one resident in Country X. Because the United States, as the residence State, views ThirdCo as a company, the United States member is not taxed on a flow-through basis by the United States on its share of the Country F dividend. It should follow that the dividend arising in Country F should not be entitled to the benefits of the United States-Country F tax treaty.

Treaty provision

In order to provide clarity in such situations, the Committee may wish to consider adopting a rule into the United Nations Model. The following text is proposed for consideration:

> **For the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.**

Additional treaty provisions

In order to achieve the desired result in example 3, it would be necessary to include in the Model, in addition to the above-mentioned draft provision, a provision that grants to a Contracting State the authority to tax its residents as if there were no Convention. Beyond achieving the desired result of example 3, such a provision would also be a valuable way of ensuring that residents of a Contracting State do not use a tax treaty to reduce the tax owed to that State by, for instance,

routing domestic source dividends through a company in the treaty partner. The following text is proposed for consideration:

[X.] Except to the extent provided in paragraph [Y], this Convention shall not affect the taxation by a Contracting State of its residents (as determined under article 4 (resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may be taxed in accordance with the laws of that Contracting State.

While as a general matter of policy, it should be the case that a Contracting State retains the right to tax its residents, there may be narrow instances in which a country may wish to provide certain treaty benefits to its own residents. The following provision provides a number of narrow exceptions to proposed paragraph [X]:

[Y.] The provisions of paragraph 4 shall not affect:

(a) The benefits conferred by a Contracting State under paragraph 2 of article 9 (associated enterprises), paragraph 7 of article 13 (gains), subparagraph (b) of paragraph 1, paragraphs 2, 3 and 6 of article 17 (pensions, social security, annuities, alimony and child support), paragraph 3 of article 18 (pension funds) and articles 23 (relief from double taxation), 24 (non-discrimination) and 25 (mutual agreement procedure); or

(b) The benefits conferred by a Contracting State under paragraph 1 of article 18 (pension funds), articles 19 (government service), 20 (students and trainees) and 27 (members of diplomatic missions and consular posts) upon individuals who are neither citizens of, nor have been admitted for permanent residence in, that State.

Annex III

Extracts from the United States Model Technical Explanation for corresponding tax treaty provisions[a]

Paragraph 4

Paragraph 4 contains the traditional saving clause found in all U.S. income tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided under their domestic laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of the other Contracting State performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of the other Contracting State is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (i.e., without regard to Code section 894 (a)). Subparagraph 5(a) of Article 1 also preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in the other Contracting State. See paragraph 4 of Article 23 (Relief from Double Taxation).

For purposes of the saving clause, "residence" is determined under Article 4 (Resident). Thus, an individual who is a resident of the United States under the Code (but not a U.S. citizen) but who is determined to be a resident of the other Contracting State under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. The United States would not be permitted to apply its domestic law to that person to the extent that its law is inconsistent with the Convention.

However, the person would still be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of subpart F income recognized by the corporation. See Treas. Reg. section 301.7701(b)-7(a)(3).

Under paragraph 4, each Contracting State also reserves its right to tax former citizens and former long-term residents in accordance with domestic law. Thus, paragraph 4 allows the United States to tax former U.S. citizens and former U.S. long-term residents in accordance with Section 877 of the Code. Section 877 generally applies to a former citizen or long-term resident of the United States who relinquishes citizenship or terminates long-term residency before June 17, 2008 if he fails to certify that he has complied with U.S. tax laws during the 5 preceding years, or if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status; or (b) the net worth of such individual as of the date of the loss of status.

[a] Secretariat note: the text of annex III is based not only on the 2006 United States Model Income Tax Convention, but also on current United States views and practice. A new version of the United States Model Technical Explanation, which will reflect such views and practice, is currently proposed.

The United States defines "long-term resident" as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of the other Contracting State under this Convention, or as a resident of any country other than the United States under the provisions of any other U.S. tax treaty, and the individual does not waive the benefits of the relevant tax treaty.

Paragraph 5

Paragraph 5 sets forth certain exceptions to the saving clause. The referenced provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under domestic law.

Subparagraph 5 (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.

(2) Paragraph 7 of Article 13 (Gains) coordinates the tax systems of the Contracting States to avoid double taxation that could result from the imposition of an exit tax or similar regime on an individual who ceases to be treated as a resident (as determined under paragraph 1 of Article 4 (Resident)) of on Contracting State and becomes a resident of the other Contracting State.

(3) Subparagraph 1 (b), paragraphs 3 and 6 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support), provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.

(4) Paragraph 3 of Article 18 (Pensions Funds) provides an exemption for certain investment income of pension funds located in the other Contracting State.

(5) Article 23 (Relief from Double Taxation) confirms to citizens and residents of one Contracting State the benefit of a credit for income taxes paid to the other or an exemption for income earned in the other State.

(6) Article 24 (Non-Discrimination) protects residents and nationals of one Contracting State against the adoption of certain discriminatory taxation practices in the other Contracting State.

(7) Article 25 (Mutual Agreement Procedure) confers certain benefits on citizens and residents of the Contracting States in order to reach and implement solutions to disputes between the two Contracting States. For example, the competent authorities are permitted to use a definition of a term that differs from an internal law definition. The statute of limitations may be waived for refunds, so that the benefits of an agreement may be implemented.

Subparagraph 5 (b) provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (e.g., in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (i.e., in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with the statutory rules. The benefits preserved by this paragraph are: the host country exemptions for government service salaries and pensions under Article 19 (Government Service), certain income of visiting students and trainees under Article 20 (Students and Trainees) and the income of diplomatic agents and consular officers under Article 27 (Members of Diplomatic Missions and Consular Posts); and the beneficial tax treatment of pension fund contributions under paragraph 1 of Article 18 (Pension Funds).

Paragraph 6

Paragraph 6 addresses special issues presented by the payment of items of income, profit or gain to entities that are either wholly or partly fiscally transparent, such as partnerships, estates and trusts. Because countries may take different views as to when an entity is wholly or partly fiscally transparent, the risk of both double taxation and double non-taxation is relatively high. The provision, and the corresponding requirements of the substantive rules of the other Articles of the Convention, should be read with two goals in mind. The intention of paragraph 6 is to eliminate a number of technical problems that could prevent investors using such entities from claiming treaty benefits, even though such investors would be subject to tax on the income derived through such entities. The provision also prevents a resident of a Contracting State from claiming treaty benefits in circumstances where the resident investing in the entity does not take into account the item of income paid to the entity because the entity is not fiscally transparent in its State of residence.

In general, the principles incorporated in this paragraph reflect the regulations under Treas. Reg. section 1.894-1(d). Treas. Reg. 1.894-1(d) (3)(iii) provides that an entity will be fiscally transparent under the laws of an interest holder's jurisdiction with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly by the interest holder. Entities falling under this description in the United States include partnerships, corporations that have made a valid election to be taxed under Subchapter S of Chapter 1 of the Code ("S corporations"), common investment trusts under section 584, simple trusts and grantor trusts. This paragraph also applies to payments made to other entities, such as U.S. limited liability companies ("LLCs"), that may be treated as either partnerships or as disregarded entities for U.S. tax purposes. Entities falling under this description in the other Contracting State include _____.

Under paragraph 6, an item of income, profit or gain derived by or through such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if a resident is treated under the taxation laws of that State as deriving the item of income. For example, if a company that is a resident of the other Contracting State pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treats one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law) as deriving the interest for U.S. tax purposes. Where the entity is a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the interest income through the partnership. Also, it follows that persons whom the United States treats as partners but who are not U.S. residents for U.S. tax purposes may not claim a benefit under the Convention for the interest paid to the partnership, because such third-country partners are not residents of the United States for purposes of claiming this benefit. If, however, the country in which the third-country partners are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with the other Contracting State, they may be entitled to claim a benefit under that convention (these results would also follow in the case of an entity that is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single-owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for tax purposes under the laws of the other Contracting State. In contrast, where the entity is organized under U.S. laws and is classified as a corporation for U.S. tax purposes, interest paid by a company that is a resident of the other Contracting State to the U.S. corporation will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.

The same result would be reached even if the tax laws of the other Contracting State would treat the entity differently (e.g., if the entity were not treated as fiscally transparent in the source State in the first example above where the entity is treated as a partnership for U.S. tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The outcome would be identical regardless of where the entity is organized (i.e., in the United States, in the other Contracting State or, as noted above, in a third country), subject to the saving clause of paragraph 4.

For example, income from U.S. sources received by an entity organized under the laws of the United States, which is treated for tax purposes under the laws of the other Contracting State as a corporation and is owned by a shareholder who is a resident of the other Contracting State for its tax purposes is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the U.S. entity.

These principles also apply to trusts to the extent that they are wholly or partly fiscally transparent in either Contracting State. For example, suppose that X, a resident of the other Contracting State, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust. If, under the laws of the other Contracting State, X is treated as taking the trust's income into account for tax purposes, the trust's income would be regarded as being

derived by a resident of the other Contracting State. In contrast, since the determination of deriving an item of income, profit or gain is made on an item by item basis, it is possible that, in the case of a U.S. non-grantor trust, the trust itself may be able to claim benefits with respect to certain items of income, such as capital gains, so long as it is a resident liable to tax on such gains, but not with respect to other items of income that are treated as income of the trust's interest holders.

As noted above, paragraph 6 is not an exception to the saving clause of paragraph 4. Accordingly, paragraph 6 does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a U.S. LLC with members who are residents of the other Contracting State elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether the other Contracting State views the LLC as fiscally transparent.